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UNCLAS SECTION 01 OF 03 SAN SALVADOR 002541

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TAGS: ECON ETRD EINV ES CAFTA
SUBJECT: CAFTA BRINGS HOPE TO SLUGGISH SALVADORAN ECONOMY

REFS: A) San Salvador 587, B) 2004 San Salvador 3181

Summary

¶1. GDP grew by a lackluster 1.6 percent during the first quarter of 2005. Official data have not been released yet for the second quarter, but a Central Bank indicator based on real production data suggests that the economy continued to perform poorly. High oil prices are taking a toll on economic activity, and the government lowered its forecast for 2005 GDP growth from 2-3 percent to 1.5-2.5 percent. CAFTA ratification has improved expectations for economic growth, but whether that promise is delivered depends on how well El Salvador takes advantage of not only CAFTA-DR's trade benefits but opportunities for institutional reform as well. End summary.

Lackluster Economic Growth

¶2. The Central Bank reports the economy grew at an annual rate of 1.6 percent during the first quarter of 2005, not much better than the 1.5 percent growth reported during the last quarter of 2004. For the second quarter of 2005, official data have not yet been released, but the Central Bank's Index of the Volume of Economic Activity (IVAE), based on real production data, suggests that the economy continued to perform poorly. Overall, the IVAE shows a 1.1 percent fall in economic activity for May and 1.8 percent fall for April. Think-tank Foundation for Economic and Social Development (FUSADES) recently released its second quarter economic report, which also reported that growth was weak during the quarter. High oil prices are taking a toll on economic activity overall, and the Central Bank lowered its forecast for 2005 GDP growth from 2 to 3 percent to 1.5 to 2.5 percent.

¶3. Looking at the economy sector by sector, performance remains poorest in the construction sector, where the IVAE showed a 21.3 percent contraction. The retail sector was flat during the second quarter according to the Central Bank indicator--FUSADES' survey of businesses confirms this result. Meanwhile, the agricultural sector continued to post positive results, thanks to favorable international prices of the traditional crops, coffee and sugar. Other sectors showing expansion were financial services, transportation, and energy.

¶4. As in previous FUSADES surveys, businesses blamed higher energy costs for the deceleration in economic activity. Crime has also become a significant factor according to survey respondents (septel). For the first time in more than a year, businesses surveyed by FUSADES have a negative perception of the investment climate, and consumer confidence is weak as well. The FUSADES survey was completed prior to the U.S. passage of CAFTA-DR, however, so these survey results may not reflect current sentiment.

Formal Employment Growing Slowly

¶5. The FUSADES survey of local businesses shows that formal sector employment may have grown by as much as 2 percent during the second quarter of 2005. The number of maquila workers, about 16 percent of total social security contributors, fell by 8 percent, while the number of workers in other sectors increased by 5 percent, offsetting the maquila decline. What is unclear, however, is whether there were actually new jobs created during the period, or more previously informal employment is now covered under Social Security--either would be a welcome development.

High Oil Prices Drive Inflation

¶6. The inflation rate during the second quarter of 2005 increased slightly over the first quarter of the year. Ministry of Economy data show a 2.1 percent rate for April and a 2.9 percent for May and June. Annual inflation for the period ending June 2005 reached 5.1 percent, well above the previous year's rate of 2.8 percent. Oil prices are the main factor behind price increases during the period. In response to U.S. Federal Reserve Bank rate increases, lending rates for short-term loans increased by 6.9 percent during the second quarter, but for loans over one year they only

increased by 0.6 percent. Deposit rates have shown a more mixed behavior, with some increasing and some diminishing. Excess liquidity in the system and low levels of economic activity have helped to maintain these rates relatively stable.

Trade Deficit Growing

¶7. The trade deficit grew by 11.5 percent between January and June of 2005, reaching $1,543.5 million. Total exports grew by 7.3 percent, while imports increased by 9.3 percent. The increase in exports was led by nontraditional goods such as ethnic foods, tuna and packaging materials, which increased by 10.4 percent to $700 million, and also by the recovery of traditional exports, which increased by 42.9 million up to $156.6 million. Coffee exports grew by 37.7 percent due to the recovery of coffee prices. Sugar exports also benefited from good international prices and a larger demand increasing by 28 percent. Maquila exports grew by only 1.1 percent to $883.8 million.

Remittances Continue Steady Growth

¶8. Remittances have continued their steady growth, reaching $1,379.3 million by the end of June of 2005, 14.3 percent higher in relation to the same period of 2005. With the reduction of the Hispanic unemployment rate in the United States, remittance flows are expected to continue to perform well during the rest of the year and eventually surpass the $2.7 billion mark by December 2005.

Tax Reforms Bolster Government Revenues

¶9. Fiscal reforms implemented in January 2005 (Ref. B) have led to a substantial increase in tax revenues during the first half of 2005, up 16 percent in relation to the first half of 2004; revenues reached $1,145 million, $48 million higher than expected. VAT revenues grew by 13 percent, reaching $579.9 million. Income tax revenues increased by 21.1 percent, up to $422.3 million. FUSADES projects that under certain assumptions tax collection could grow to 12.6 percent of GDP by the end of 2005.

¶10. FUSADES' quarterly report highlights the budget pressure created by pension costs and rising international interest rates. Although impressive, the increase in tax collection will not be enough to service existing debt for 2005. By June 2005, the fiscal deficit was an accumulated $53 million, higher than the $23 of the previous year, and public debt as a percentage of GDP climbed to 44.3 percent of GDP. However, with municipal and legislative elections on the horizon, it is unlikely the government will either cut spending or increase taxes until Summer 2006.

High Hopes for CAFTA-DR Trade Benefits

¶11. Optimism--although tempered by rising oil prices--is the rule among government officials and the private sector now that CAFTA-DR is law in the United States. CAFTA-DR is viewed as the panacea for the sickly Salvadoran economy; it will boost exports, generate new employment, and attract foreign investment. Government officials, especially at the Ministry of Economy, are energized and actively working to assist exporters in taking advantage of CAFTA-DR trade benefits. The government is working toward implementation of CAFTA-DR in anticipation of the January 1, 2006 implementation date. Long before CAFTA-DR ratification, the government had instituted a comprehensive trade capacity building program, with the aid of international donors, especially USAID.

¶12. Federico Colorado, President of the National Association of Private Businesses (ANEP), which represents big business, said after passage that CAFTA-DR is what the country needed to push economic growth: "There were firms waiting for the signature of the agreement to invest in the country. This agreement will have an impact in many aspects--investment, employment generation, and wealth--in a very positive way." Ricardo Esmahan, President of agricultural sector organization CAMAGRO, is also looking at the bright side, and he recently said that CAFTA-DR is a valuable opportunity for the country, but the challenge is how to take advantage of it. Maximiliano Portillo, representative of a small business association, called on his members to be prepared to export to the U.S. market and take advantage of the opportunities offered.

Comment: CAFTA-DR Institutional Reform also Essential
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¶13. Trade benefits under CAFTA-DR are the most tangible aspect of the agreement, so it is understandable that Salvadorans focus on them. In the long term, however, much of CAFTA-DR's promise for El Salvador lies in the institutional changes that it could bring about. Post is working to remind Salvadorans that CAFTA-DR's potential to transform the Salvadoran economy also requires faithful

implementation of provisions related to telecommunications, banking, and electronic commerce, environmental and labor rights, intellectual property rights, investment, and dispute resolution. So far, we are encouraged by the commitment demonstrated by the government, especially in the Ministry of Economy.

¶14. The United Nations Development Program (UNDP) recently released its human development report, which warns that pursuing export-led growth--without complementary measures to improve the competitiveness of the country--has produced poor economic results for El Salvador. UNDP argues that El Salvador's export-led growth strategy introduced in 1989, combined with dollarization and the immigration/remittances flow, eroded the country's export competitiveness by pushing up the real exchange rate. The lesson we hope the Salvadorans will take away from this report is not that they should abandon export-led growth, but that they should do so while also pushing forward with "second generation" economic reforms needed to make their private sector more competitive, especially in the financial sector to improve access to credit (Ref. A) and in the judiciary to resolve commercial disputes fairly and quickly. We hope CAFTA-DR implementation will give them the political cover they will need to undertake these difficult reforms. End comment.

BARCLAY